OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM TO THE FIELD

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

This Field Service Advice is in response to your memorandum dated September 17, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. Field Service Advice issued to Examination or Appeals is advisory only and does not resolve Service position on an issue or provide the final basis for closing a case. This document is not to be relied upon or otherwise cited as precedent.

LEGEND:

Purchaser =

Taxpayer =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

ISSUE:

Whether Purchaser had an "option to acquire" the stock of Taxpayer and therefore constructively owned the stock in Year 1. §318(a)(4)

CONCLUSION:

Based on the facts submitted and assuming the conditions precedent to exercising the options were present on December 31 of Year 1, Purchaser did not have an “option” in Year 1 for purposes of IRC §318 and therefore did not constructively own the stock of Taxpayer in Year 1.

FACTS:

On Date 1, a Stock Option Agreement (Option Agreement) was entered into between Purchaser and representatives of the shareholder that controlled the majority of the Taxpayer’s stock. The Option Agreement granted Purchaser an “irrevocable option to purchase all of the shares legally or beneficially owned by such stockholder, at such time as Purchaser may exercise the stock option during the exercise period at a purchase price equal to the offer price. . .” The exercise period began in Year 2, on Date 3. Also on Date 1, Purchaser and Taxpayer executed a Merger Agreement.

The Option Agreement and Merger Agreement provided several ways the Agreement could be terminated. These included: 1) the Option Agreement and Merger Agreement would terminate if Taxpayer received an offer to purchase that exceeded Purchaser’s offer; 2) the Option Agreement and Merger Agreement would terminate without timely approval under the Hart-Scott-Rodino antitrust provisions; and 3) the Option Agreement and Merger Agreement would terminate if Purchaser could not obtain proper financing to consummate the purchase. On Date 4, Purchaser exercised its option and acquired the stock of Taxpayer.

Your question is whether, under the above facts, Purchaser constructively owned the stock of Taxpayer in Year 1. You state that on Date 2, Taxpayer paid section 280G payments to several executives.

LAW AND ANALYSIS:

IRC §280G provides that no deduction will be allowed for any excess parachute payment. IRC §280G(b)(1) defines the term "excess parachute payment" as an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

IRC §280G(b)(2)(A) defines the term "parachute payment" as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation; and (ii) the aggregate present value of the payments in the nature of

compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount.

Section 1.280G-1 of the Proposed Income Tax Regulations, Q&As 27, 28 and 29, published in the Federal Register on May 5, 1989, (54 Fed. Reg. 19,390), provides guidance concerning when a corporation will be considered to have undergone a change in ownership or effective control, or a change in the ownership of a substantial portion of its assets. All three Q&As provide that §318 will apply in determining stock ownership. See Q&A 27(c), Q&A 28(d), and Q&A 29(c).

Under IRC §318(a)(4), a person who has an option to acquire stock is deemed to own the optioned stock. Warrants, convertible debentures, and other noncontingent rights to obtain stock at the holder's election will result in attribution for the optioned shares. Contingencies that remove the election from the optionee's unilateral control generally prevent attribution. Rev. Rul. 68-601, 1968-2 C.B. 124. See also Boris I. Bittker & James S. Eustice, Federal Income taxation of Corporations and Shareholders, ¶ 9.02[5], at pp. 9-16 to 9-17 (6th ed. 1998).

The facts indicate that there are serious conditions precedent which could result in a substantial risk of forfeiture of Purchaser's right to exercise the option, and so he cannot be said to have the right to obtain the underlying stock at his election. Both the Option Agreement and the Merger Agreement, by their terms could be terminated as described above. Thus, it can not be seriously argued that, on the day of purchase of the option, Purchaser had the right to obtained the stock at his election. Clearly, Purchaser's ability to exercise the option was seriously restricted. He could only have exercised the option at his election on or after Date 3, provided that in the interim period none of the contingencies regarding termination occurred.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call

MARY E. OPPENHEIMER

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